



Signed and Filed: November 2, 2012

Dennis Montali

DENNIS MONTALI
U.S. Bankruptcy Judge

UNITED STATES BANKRUPTCY COURT
NORTHERN DISTRICT OF CALIFORNIA

In re) Bankruptcy Case
JAMES WILKES MILNES,) No. 10-33136DM
Debtor.)
MEGAN WONG, WARREN WONG, DIANNA) Adversary Proceeding
WONG, HANS KUFFER, ELSBETH KUFFER,) No. 10-3193DM
PHILLIP DIEP, JENNY TRAC, JOSEPH)
CANATSEY, MICHELLE CANATSEY, JUNE)
FUJI, DENNIS POOR, DENISE POOR,)
MARK MISTAL and KITTYHAWK PRODUCTS,)
INC., a Nevada Corporation,)
Plaintiffs,)
v.)
JAMES MILNES, individually and)
dba JB LAND DEVELOPMENT, and dba)
AMERICAN PRIME FUNDING,)
Defendant.)

MEMORANDUM DECISION ON SUBMITTED MOTIONS

On September 13, 2012, the court held a hearing on the following motions: (1) Defendant's motion to dismiss or in the alternative for judgment on the pleadings ("Motion to Dismiss";

1 (2) Defendant's motion to vitiate, withdraw or amend automatic
2 admissions; (3) Plaintiffs' motion for summary judgment ("Motion
3 for Summary Judgment"); (4) Plaintiffs' motion for leave to file
4 supplemental or amended complaint ("Motion to Amend"); and (5)
5 Defendant's motion to compel discovery. The court took the
6 motions under submission. For the following reasons, the Motion
7 to Dismiss will be granted in part and denied in part; the
8 Defendant's motion to vitiate admissions will be granted; the
9 Motion for Summary Judgment will be denied; the Motion to Amend
10 Complaint is denied; and the Defendant's motion to compel
11 discovery will be denied.

12 I. **FACTS**

13 A. *Plaintiffs' Allegations*

14 For the purposes of these motions, the court will assume as
15 true the allegations of the Plaintiffs in the erroneously titled
16 "Fourth Amended Complaint"¹ attached as an exhibit to the Motion
17 to Amend. Plaintiffs contend that Defendant participated in a
18 scheme with William Peavey ("Peavey") (a business partner and co-
19 owner of JB Land Development, LLC ("JB Land")) to induce them to
20 purchase tenancy in a common interests in various properties which
21 would be developed for various purposes (e.g., as a mini-storage
22 units, as an equestrian estate, etc.). See paragraph 38 of the
23 Proposed Amended Complaint.

24
25 ¹This is actually the fifth amended complaint; as discussed
26 later, a different fourth amended complaint was filed (without
27 leave of court) on October 24, 2011. For the purposes of this
28 memorandum decision, the court will refer to the erroneously-
titled complaint attached to the Motion to Amend as the "Proposed
Amended Complaint."

1 Plaintiffs allege, among other things, that Defendant and
2 Peavey never had any intent to develop the properties, that they
3 induced the Plaintiffs to invest by making promises that they knew
4 were false at the time they made them, and that they knowingly
5 misrepresented the status of the properties. They also allege
6 that Defendant and Peavey withdrew funds from escrow without
7 authority. Based on these and other factual allegations,
8 Plaintiffs contend that debts owed to them by Defendant are
9 nondischargeable under 11 U.S.C. §§ 523(a)(2)² (for false
10 representation or fraud), 523(a)(4) (for both breach of fiduciary
11 duty and embezzlement), 523(a)(6) (for willful and malicious
12 injury) and 523(a)(19) claim (for a debt that (1) is for the
13 violation of securities laws or fraud or deceit in connection with
14 the sale of a security and (2) "results from" a judgment or order
in a federal or state judicial or administrative proceeding).

16 B. Procedural History

In February 2011, Defendant filed his first motion to dismiss the claims alleged by Plaintiffs in their second amended complaint. Among other things, Defendant argued that their section 523(a)(19) claim was not ripe as no debt existed that arose from a "judgment, order consent order, or decree" pertaining to a violation of securities laws or fraud/deceit/manipulation in connection with the sale of a security. That motion to dismiss was taken off calendar after Plaintiffs and Defendant filed a stipulation [Docket No. 29] permitting Plaintiffs to amend the

²⁷Unless otherwise indicated, all chapter, section and rule
28 references are to the Bankruptcy Code, 11 U.S.C. §§ 101-1532, and
to the Federal Rules of Bankruptcy Procedure, Rules 1001-9037.

1 complaint to remove the securities violation (section 523(a)(19))
2 claim, to remove a breach of fiduciary duty (section 523(a)(4))
3 claim, and to allege additional facts to support a section
4 523(a)(2) claim. Plaintiffs thereafter filed a third amended
5 complaint in accordance with this stipulation, which Defendant
6 answered.

7 On August 31, 2011, the court signed an amended scheduling
8 order setting a discovery deadline of December 11, 2011, and
9 providing in paragraph 2 that motions to amend the pleadings had
10 to be filed not later than 30 days after entry of the order.
11 Almost 60 days later (on October 24, 2011), Plaintiffs filed an
12 untimely fourth amended complaint, but did not file a motion for
13 leave to do so. That fourth amended complaint repeated the
14 allegations from the first two complaints regarding violations of
15 California securities laws, but did not specifically mention
16 section 523(a)(19).

17 On August 6, 2012, Plaintiffs filed the Motion to Amend;
18 among other things, Plaintiffs seek to reassert the section
19 523(a)(19) claim, basing the amendment on a Desist and Refrain
20 Order issued by the California Corporations Commissioner in May
21 2012 that described violations of securities laws by Defendant and
22 that prohibited him and Peavey from offering or selling securities
23 in California. The Proposed Amended Complaint has not been filed,
24 but is attached as an exhibit to the Motion to Amend.

25 C. *Desist and Refrain Order*

27 On May 23, 2012, the California Department of Corporations
28 issued a Desist and Refrain Order "For Violations of Section 25110

1 and 25401 of the Corporations Code" (the "Desist & Refrain
2 Order"). The Desist & Refrain Order described the background of
3 the investments by Plaintiffs and concluded that Defendant was
4 president of JB Land and operated as a broker under the realtor
5 Golden Pacific Real Estate ("Golden Pacific"). The order
6 contained the following findings:

- 7
- 8 2. Peavey, [Defendant], JB Land and Golden Pacific offered
9 and sold securities in this state including promissory notes
10 and investment contracts in the form of tenant in common
11 interests in real property. These offers and sales to at
12 least 8 investors totaled \$1,427,500 and took place between
13 2007 and 2009.³
- 14
- 15 3. Investors were assured of returns ranging from 20% to 25%
16 for investments that were to mature in periods ranging from 3
17 months up to one year. Purchase agreements were offered to
18 investors that promised JB Land would buy back property in
19 one year with a guaranteed return of principal and 25%
20 interest. The contract stated that JB Land would exercise
21 exclusive management and control of the property development
22 and take all necessary steps to carry out the development
23 plan.
- 24
- 25 4. The promise and the personal guarantee of that promise by
26 Peavey and [Defendant] to repurchase land with a guaranteed
27 return was false and known to Peavey and [Defendant] to be
28 false at the time it was made. The investment scheme outlined
herein was offered and sold to at least 35 investors. In
multiple transactions, the language of the purchase contracts
issued by JB Land was identical, except for the dollar
amounts and the investor names. The fundamental premise of
each purchase agreement was the development of bare land. Not
one identifiable structure was ever completed. No funds were
ever repaid to the investors, other than when Peavey made an
interest payment to encourage an investor to roll over the
principal invested.

23 3The Desist & Refrain Order does not identify the affected
24 investors. As acknowledged by Plaintiffs, other individuals and
25 entities were investors in JB Land and were the victims of
26 "similar schemes with separate projects with similar results."
27 See paragraph 60 of the Proposed Amended Complaint. This
28 adversary proceeding was filed by 14 plaintiffs who had allegedly
paid Defendant \$2.2 million in 2006, 2007 and 2008. See
paragraphs 18-29 of the Proposed Amended Complaint. In contrast,
paragraph 2 of the Desist & Refrain Order states that "at least
eight" unidentified investors paid \$1,427,500 between 2007 and
2009.

* * *

6. The promissory notes and purchase agreements executed by Peavey and [Defendant] and on behalf of JB Land and Golden Pacific were securities in the form of notes or investment contracts, and were offered or sold in this state in issuer transactions. The California Corporations Commissioner is of the opinion that the securities in JB Land and Golden Pacific offered and sold by Peavey and [Defendant] are subject to qualification under the California Corporate Securities Law of 1968 and are being or have been offered or sold without being qualified in violation of Corporations Code section 25110.

7. Further, the California Corporations Commissioner is of the opinion that the securities in JB Land and Golden Pacific were offered or sold in this state by means of oral or written communications which included an untrue statement of a material fact or omitted to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, in violation of section 25401 of the Corporate Securities Law of 1968.

8. The Commissioner believes that at all relevant times, Peavey and [Defendant] directly and indirectly knowingly controlled and induced each other or knowingly provided substantial assistance to each other to violate the provisions of the Corporate Securities Law within the meaning of Corporations Code section 25403.

See Desist & Refrain Order attached as Exhibit "C" to the Motion for Summary Judgment (emphasis added). The Desist & Refrain Order does not indicate whether (or how) Defendant was served with it. Moreover, as noted in footnote 3 above, it does not identify the affected investors. Finally, it does not grant relief to the investors; it simply restrains Defendant and Peavey from selling or issuing securities.

II. ANALYSIS

A. *Defendant's Motion to Dismiss or for Entry of Judgment on the Pleadings*

Defendant requests that this court dismiss the section 523(a)(2) claims by Plaintiffs, contending that they have not plead with sufficient particularity the facts to support an action

1 for fraud. The court will deny this request as the amended
2 complaint sufficiently sets forth in paragraphs 17-79 the
3 transactions and facts to state a section 523(a)(2) claim that is
4 plausible on its face. Ashcroft v. Iqbal, 129 S.Ct. 1937, 1949-50
5 (2007).

6 Defendant also contends that Plaintiffs have not alleged
7 facts to support a section 523(a)(4) claim. In their opposition
8 to the Motion to Dismiss, Plaintiffs argue that they have a claim
9 for breach of fiduciary duty, even though they stipulated in 2011
10 [Docket No. 29] to dismiss that claim and even though neither the
11 filed fourth amended complaint nor the Proposed Amended Complaint
12 mentions breach of fiduciary duty. To the extent that Plaintiffs
13 are indeed attempting to assert a claim for breach of fiduciary
14 duty, the court will grant Defendant's Motion to Dismiss that
15 claim for several reasons.
16

17 First, Plaintiffs waived the breach of fiduciary duty claim
18 in the stipulation. Second, even if the breach of fiduciary duty
19 had not been waived, the neither the Fourth Amended Complaint nor
20 the Proposed Amended Complaint pleads the existence of any express
21 or technical trust giving rise to a fiduciary duty by Defendant to
22 Plaintiffs. Therefore, a breach of fiduciary duty claim under
23 section 523(a)(4) is not sustainable. In re Lewis, 97 F.3d 1182,
24 1185 (9th Cir. 1996) ("The broad, general definition of
25 'fiduciary' is inapplicable in the dischargeability context.
Instead, the fiduciary relationship must be one arising from an
express or technical trust that was imposed before and without
reference to the wrongdoing that caused the debt.").

1 Defendant also contends that the embezzlement count of the
2 section 523(a)(4) should be dismissed. In order to prevail on a
3 section 523(a)(4) claim for embezzlement, the Plaintiffs will have
4 to establish the following elements: (1) Defendant was rightfully
5 in the possession of property that he did not own; (2) Defendant
6 appropriated the property to a use other than for which it was
7 entrusted to him, and (3) circumstances indicating fraud existed.
8 In re Littleton, 942 F.2d 551, 555 (9th Cir. 1991).

9 Paragraphs 18-38 of the Proposed Amended Complaint allege
10 that Plaintiffs conveyed funds to Defendant to acquire tenancy in
11 common interest in parcels of real property and that they did
12 receive such fractional interests. Defendant (and/or Peavey
13 and/or JB Land) agreed to repurchase the fractional interests at a
14 significant profit within two years. Based on those allegations,
15 Plaintiffs did not have an ownership interest in the funds paid to
16 Defendant (or JB Land); rather, they acquired ownership interests
17 in land and expected to receive a quick and profitable price on
18 that investment. To the extent such funds were paid to JB Land
19 (or to Defendant as alleged in paragraphs 18-29 of the Proposed
20 Amended Complaint), ownership of such funds passed to JB Land or
21 Defendant, and one cannot embezzle one's own property. In re
22 Schultz, 46 B.R. 880, 890 (Bankr. D. Nev. 1985). The court will
23 therefore grant the Motion to Dismiss with respect to the
24 embezzlement claim.

25
26 Defendant also requests the court to dismiss Plaintiffs'
27 523(a)(6) claim for willful or malicious injury. The court will
28 not do so, as the findings of the California Department of

1 Corporations in the Desist & Refrain Order and the allegations in
2 the Fourth Amended Complaint sufficiently set forth a basis for a
3 section 523(6) claim. In particular, if those findings and the
4 allegations of the complaint are accurate, Defendant seemingly
5 committed intentional torts. In In re Diamond, 285 F.3d 822 (9th
6 Cir. 2002), the Ninth Circuit held that the facts that supported a
7 section 523(a)(2) claim also supported a section 523(a)(6) claim,
8 as the actions of the debtors giving rise to a fraud claim under
9 section 523(a)(2) also gave rise to a state court jury finding
10 that the defendants intentionally caused injury to the plaintiffs.
11 There, sellers of a house completed a property condition checklist
12 indicating no knowledge of any flooding, seepage, standing water
13 or drainage problems on the property. The purchasers soon
14 thereafter experienced extensive flooding of their backyard and
15 basement, and filed a state court complaint for fraudulent
16 concealment, fraud, breach of contract and other causes of action.

17 The sellers filed bankruptcy, but did not inform the state
18 court or purchasers. A two-day jury trial thus proceeded in the
19 absence of the sellers/debtors, and the jury answered the
20 following questions affirmatively:

- 21 (1) Do you find that the defendants' conduct constituted
22 fraud or false representation?
23 (2) Do you find that the plaintiffs justifiably relied
24 on the defendants' representations?
25 (3) Do you find that the defendants intentionally caused
26 injury to the plaintiffs without just cause or excuse?

27 Id. at 825.

28 The bankruptcy court thereafter annulled the automatic stay
and the state court entered a judgment against the

1 defendants/debtors; the purchasers filed an action to have the
2 judgment declared nondischargeable. Applying the doctrine of
3 issue preclusion, the bankruptcy court entered a judgment against
4 the debtors under section 523(a)(2) and (a)(6) claims. The BAP
5 affirmed. The Ninth Circuit affirmed, observing that the debtors
6 committed a "willful and malicious injury" to the purchasers when
7 they sold the property to them. This holding indicates that
8 section 523(a)(2) and section 523(a)(6) claims are not necessarily
9 mutually exclusive, so the court will not dismiss the section
10 523(a)(6) claims at this time.

11 Defendant also contends that the section 523(a)(19) claims
12 for securities violations should be dismissed because the
13 California Corporations Code exempts real estate transactions from
14 the statutory requirements for the sale and issuance of securities
15 and because there "is not final resolution" as to Defendant's
16 liability for a violation of securities laws. While the court is
17 not persuaded by the exemption argument, it does agree that
18 Plaintiffs have not yet sufficiently pled the existence of the
19 elements of a section 523(a)(19) claim.
20

21 The Desist & Refrain Order indicates in paragraphs 6-8 that
22 Defendant did violate the California Corporations Code, including
23 section 25110, so Debtor's arguments that the transactions at
24 issue were exempt from California securities laws are not well-
25 taken. However, whether or not the Desist & Refrain Order is
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27
28

1 final,⁴ section 523(a)(19) has two separate conditions for
2 nondischargeability: (1) the debt must be for the violation of
3 state or federal securities law or for common law fraud, deceit,
4 or manipulation in connection with the sale of a security; and (2)
5 the debt must "result from" a judgment, order, consent order or
6 decree entered in a state or federal judicial or administrative
7 proceeding or "result from" from any court or administrative order
8 for damages or other payment.

9 Here, Plaintiffs have provided an order entered in a state
10 administrative proceeding that finds that Defendant violated
11 California securities laws and acted fraudulently or deceitfully
12 in connection with the sales of securities. However, this Desist
13 & Refrain Order does not impose any monetary liability on
14 Defendant; moreover, the obligations purportedly owed by Defendant
15 by Plaintiffs did not "result from" the Desist & Refrain Order.
16 Unless and until Plaintiffs can demonstrate that Defendant's
17 purported obligation to them "resulted from" a court or
18 administrative agency decision, any claim under section 523(a)(19)
19 is premature. That said, the findings of the California
20 Department of Corporations may have issue-preclusive effect with
21 respect to some of the elements of Plaintiffs' section 523(a)(2)

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23
24
25 ⁴California Corporations Code § 25532 provides that a desist
26 and refrain order is deemed a final order if an order has been
27 served on the person to whom it is directed, and that person fails
28 to file a written request for hearing within 30 days of service.
Plaintiffs have not provided information regarding the service of
the order on Defendant, and Defendant's counsel stated at the
hearing that Defendant was unaware of the Desist & Refrain Order
until the motion to amend was filed.

1 and (a)(6) claims, but that issue has not been fully briefed by
2 the parties.

B. Defendant's Motion to Vitiate Admissions

In their Motion for Summary Judgment (discussed below),
Plaintiffs rely on deemed admissions of Defendant resulting from
his failure to respond to Plaintiffs' request for admissions. As
the court indicated at the hearing, it is granting the motion as
the governing local rules preclude enforceability of the
admissions.

The court entered an amended scheduling order that set a discovery cut-off date of December 15, 2011. On November 17, 2011, Plaintiffs served their requests for admission on Defendant by mail. The responses were due 33 days after service of the requests by mail (30 days under Rule 7036 and Federal Rule of Civil Procedure 36(a)(3) plus 3 days under Rule 9006(f)), so the deadline for responding was December 20, 2011, five days after the discovery cut-off date.

20 Bankruptcy Local Rule 1001-2(a) incorporates Civil Local Rule
21 37-3, which provides: "Discovery requests that call for responses
22 or depositions after the applicable discovery cut-off are not
23 enforceable, except by order of the Court for good cause shown."
24 Interpreting the prior version of this local rule (then Civil
25 Local Rule 26-2), District Judge Wilken refused to consider a
26 nonresponse as a deemed admission where the deadline for the
27 response occurred after the discovery cut-off date. Commonwealth

1 Annuity and Life Ins. Co. v. Dalessio, 2009 WL 2169868 (N.D. Cal.
2 2009).

3 In Dalessio, the defendants served the request for admissions
4 on March 1 and the discovery cut-off in the case management order
5 was March 31. Noting that Fed. R. Civ. P. 6(d) adds three days to
6 the 30 day period of Fed. R. Civ. P. 36(a)(3) when the requests
7 are served by mail, Judge Wilken refused to treat the admissions
8 as deemed as the responses were due after the discovery cut-off.
9 Judge Wilken cited the local rule and concluded that "[b]ecause
10 the Request for Admissions was not timely served and no good cause
11 has been shown, the statements therein are not admitted." This
12 court will likewise follow the applicable local rules and not
13 consider Defendant's nonresponse to the untimely requests for
14 admissions as deemed admissions.

15

16 C. *Plaintiffs' Motion for Summary Judgment*

17 As the court will not treat Defendant's nonresponse to the
18 untimely requests for admission as deemed admissions, factual
19 issues exist as to the elements of Plaintiffs' section 523(a)(4)
20 and (a)(6) claims, particularly with respect to intent. Defendant
21 has filed a declaration indicating that he did not make
22 misrepresentations, but were based on his "good faith" evaluation
23 of the properties and project appraisals. He also observes that
24 the plaintiffs received deeds and titles in exchange for their
25 investments. Given that intent is a primary element of the
26 claims, Defendant's declaration places a material fact in dispute.
27 Summary judgment is therefore inappropriate at this juncture.
28

1 That said, if Plaintiffs can establish that the Desist & Refrain
2 Order has issue preclusive effect as to the elements of their
3 section 523(a)(4) and (a)(6) claims, summary judgment may
4 eventually be appropriate.

5 D. *Plaintiffs' Motion to Amend Complaint*
6

7 For the reasons set forth in the discussion of Defendant's
8 Motion to Dismiss, the court will deny Plaintiffs' Motion to Amend
9 to add a section 523(a)(19) claim until they can demonstrate that
10 their claims against Defendant "arose from" the Desist & Refrain
11 Order (or another state or federal order). If they can
12 demonstrate a right of restitution that arises as a matter of law
13 as a result of the Desist & Refrain Order, or the existence of an
14 order or judgment directing Defendant to compensate Plaintiffs or
15 investors, they can at that point reassert the section 523(a)(19)
16 claim. Under section 523(a)(19)(B), any such order or judgment
17 can be entered at any time after the petition date. Moreover, the
18 time limitations of Rule 4007 are inapplicable to a complaint for
19 determination that a debt is nondischargeable under section
20 523(a)(19).

21 E. *Defendant's Motion to Compel Discovery*
22

23 At the hearing, Defendant's counsel conceded that his motion
24 to compel discovery may have been rendered moot by Plaintiffs'
25 voluminous supplemental responses (submitted to the court on
26 September 6). Defendant reserved the right to renew his motion
27 after reviewing the responses. Therefore, the court will deny the
28 motion to compel discovery as moot.

III. CONCLUSION

For the foregoing reasons, the court will grant Defendant's Motion to Dismiss as to the section 523(a)(4) and (a)(19) claims (with leave to amend the section 523(a)(19) claims if an order or decree satisfying section 523(a)(19)'s requirements is entered). The court will deny the balance of the Motion to Dismiss. The court will grant the Defendant's motion to vitiate admissions and will deny as moot his motion to compel discovery. The court will deny the Plaintiffs' Motion for Summary Judgment and Motion to Amend the Complaint. Counsel for Defendant should upload orders for each motion consistent with this memorandum decision (and state that the motions are granted or denied for the reasons set forth in this memorandum decision and on the record of the hearing). Counsel should comply with B.L.R. 9021-1 when uploading the order.

The court will hold an adversary proceeding status conference on November 30, 2012, at 1:30 p.m.

*** END OF MEMORANDUM DECISION ***